EX PARTE OR LATE FILED

DOCKET FILE COPY ORIGINAL

RECEIVED

FEB 14 1994

FEDERAL COMMUNICATIONS COMMISSION
OFFICE OF THE SECRETARY

COLE, RAYWID & BRAVERMAN

ATTORNEYS AT LAW
SECOND FLOOR
1919 PENNSYLVANIA AVENUE, N.W.
WASHINGTON, D.C. 20006-3458
(202) 659-9750

JOHN P. COLE, JR.
BURT A. BRAVERMAN
ROBERT L. JAMES
JOSEPH R. REIFER
FRANCES J. CHETWYND
JOHN D. SEIVER
WESLEY R. HEPPLER
PAUL GLIST
DAVID M. SILVERMAN
JAMES F. IRELAND, III
STEVEN J. HORVITZ
CHRISTOPHER W. SAVAGE
ROBERT G. SCOTT, JR.
SUSAN WHELAN WESTFALL
GARY I. RESNICK
JANET R. THOMPSON*
THERESA A. ZETERBERG
STEPHEN L. KABLER
MATTHEW P. ZINN
JOHN DAVIDSON THOMAS
MARIA T. BROWNE
BENJAMIN E. GOLANT
THOMAS SCOTT THOMPSON

* ADMITTED IN PENNSYLVANIA ONLY

ALAN RAYWID
(1930-1991)

CABLE ADDRESS
"CRAB"

TELECOPIER
(202) 452-0067

February 14, 1994

Patrick Donovan
Federal Communications Commission
Room 918B
2033 M Street, N.W.
Washington, D.C.

Re: Cable Television Cost of Service
Ex Parte MM Docket 93-215

Dear Mr. Donovan:

This letter is to follow up on the meeting Amos Hostetter and I had with you and Jay Atkinson last week to discuss the cost of service rulemaking.

As the vote on the details of cable rate regulation draws near, it is imperative that the Commission's actions be grounded in a sound understanding of the financial and economic principles that actually govern the operation of the cable television industry. The purpose of this letter is to distill from Continental's prior Comments the essential financial and business realities

No. of Copies rec'd 0+
List ABCDE

of cable television operations so that the Commission will understand the real economic and financial costs of providing cable service *before* it adopts its "cost of service" regulations.

A key issue confronting the Commission in adopting cost of service rules is the nature of intangibles in the cable business. We understand that there are some who are alarmed that such a significant portion of cable assets are "intangibles," which may, they believe, be monopoly profits in disguise. We have submitted extensive financials in our Comments demonstrating that this belief is false. Instead, intangibles represent legitimate costs and investments in the cable enterprise which—while not characteristic of long-established providers of universally-penetrated utility services like telephone and electricity—are not only characteristic in cable television and a host of other businesses, but are essential to the growth of the industry.

Consider a parent purchasing a US savings bond on a payroll deduction plan to finance a child's college education. The price paid today for a long-term bond is a fraction of the bond's "face" value. The face value represents the accumulated interest on the investment, which is not paid year by year, but is allowed to accumulate until the bond matures many years in the future. If the parent were to receive from the savings bond only the amount that was put in, and if no credit were given for all of the years in which the interest was allowed to accumulate, no-one would ever invest in savings bonds.

The same is true for any investment which does not pay interest on a current basis. So-called "zero-coupon bonds," for example, are purchased for a face amount, and the purchaser knows that more interest will accumulate the longer the bond is held. At the end of its life, like the savings bond, the investor is paid back not just for his original investment, but for the use of his money for all the years the bond was held and no interest was paid.

An important feature of these types of investments—savings bonds or zero-coupon bonds—is that the longer they are held, the more interest has accumulated. In fact, there is a very active secondary market in zero-coupon bonds, which pay the holder more money the longer the bond has been held. This is based on the buyer's expectation that when the bond matures, it will compensate the ultimate owner of the bond for the use of money during the bond's maturation, and the seller's requirement that he be compensated for the time value of the money that has been tied up in the investment in the bond.

Investments in cable television systems are directly analogous to the situation just described. A cable television system does not make money in its early years. Historically, as cable systems were built, penetration in the early years was in the 30% to 40% range. With years of effort, subscribers are attracted to the system, penetration increases, and in time, usually 3½-5 years, the system reaches breakeven. But consider what has happened to the investor during that time. As with the purchaser of a savings bond or a zero-coupon bond, the investment has not yet made any money. Instead, the investor has accumulated losses (often requiring new cash investments) and foregone a return—the interest on the investment—during the time that the system was reaching breakeven.

Here is where the distinction between tangible and intangible investments begins to develop. Some of the cable system's money is spent on items such as cable and trucks, which are booked as tangible assets. But some is also used to pay rent for the office space, to pay employees their salaries and benefits and to market the service to potential subscribers. The investor capital used to pay for these items during the start-up years would not be reflected in tangible assets.

Had cable been a regulated utility during this period, the operator would have recorded these losses and the foregone return as a regulatory asset and included it in the rate base—much as the FCC allows interest during construction and state PUC's allow debt and equity costs of construction work in progress to be included in ratebase. In fact, however, cable operators who built and held their systems did not create "regulatory" assets; they were not regulated, so there was no point in doing so. Instead, their accountants wrote these expenses off as losses. But regardless of the short-term accounting treatment, the investors' expectations were unchanged: they still placed their money into use for building and developing a cable business, and they rightly expected to be compensated for the use of their money for the entire time that the money was being used. Like the person holding a US savings bond, they expected the value of the bond to increase with time, knowing that although they were foregoing a current return, and even though the business was "deficit spending," they would recover their investment and a return at the maturity of the system.

The magnitude of those early losses, however, is great, commensurate with the highly capital-intensive nature of the cable business. Continental's Brockton financials, which are unadorned, real-life standalone financials of a build and hold system, show that the early years' losses and accumulated return deficiency carry with them a real investment by the investors of \$28 million, compared with the "tangible" assets of \$20 million.[1] If Continental were to sell that system, it would have to recover the prior losses and foregone returns in order to provide a fair return to its investors for the entire period of their investment. *Most important, if we assume a customary purchase price, that return is not above the returns to investors in similar enterprises of comparable risk--and they are therefore by definition not monopolistic.*

---

[1]Nor are those losses some form of tax scheme for sheltering other income. The profits from the Brockton system are too small to absorb the losses in the year in which losses are incurred. Eventually, a system should earn enough to absorb that loss and begin to earn taxable revenues on a current basis. But as cable operators have kept up with technological revolutions, they have continued to invest in upgrades, improvements, and new facilities, starting this investment cycle over again. If the Commission is concerned about the effects in cable properties, it may simply require that recognition be taken on a system specific basis for tax benefits in the year those benefits are used—not in the year they are nominally accrued and carried forward. If that adjustment is made, the Commission will have fully purged its rules of any hidden tax benefits. In any event, concern about the operations of the tax law hardly justifies ignoring millions of dollars of investor capital actually used to develop the cable business.

The Commission's problem with intangibles, we believe, is closely tied to the conviction by many that some systems were routinely "flipped" by some cable operators at higher and higher purchase prices, and that the investment has been artificially distorted. We have said before, and repeat now, that we do not contend that every dollar booked as an intangible in an acquired system is automatically to be included in ratebase. Some acquisitions may have included some irrational excess price. But the Commission must not let anecdote be the dispositive element in its handling of intangibles in cable television. Nor could any concern about "excess" acquisition prices justify a blanket rule excluding all intangibles, or even a general presumption that they should be excluded. At most, such concerns could justify a requirement that additional information be provided in cases where a system has changed hands with undue frequency.

The US Savings bond analogy illustrates the point. If you have held a savings bond for five years, and it has five more years to maturity, you would not rationally sell the bond for the amount of money you paid to first buy it. You have already accrued some value for foregoing the interest while that money was being used by the government. If you sold it to the bank, you would be paid a premium above your purchase price, depending on how long you have held it. No one would accuse you of having obtained an illicit premium or accuse the bank of paying an unsavory acquisition premium because you are being compensated for your foregone return for the years you held it. When the bank holds the bond to maturity, it will be paid the face amount—reflecting the full 10 years' worth of interest—which will have been partially offset by the amount of accumulated interest it paid you when it bought the bond in the middle of its life.

When a buyer of a cable system approaches a seller, that seller has almost identical expectations. It has incurred losses and foregone current returns during the development of the system. The seller will not rationally sell the system for only the price it paid for wire or other hard assets: it needs to get a return to its investors for the money they paid for operating expenses, and the return they did not insist upon getting during startup years. Like the build and hold system, this will be a sizeable amount above the hard assets, but there is nothing illicit or monopolistic about it. Indeed, when we compared in Continental's Comments the financials for a typical build and hold system with the financials for a typical acquisition system, we demonstrated that the purchase price was almost identical to what Continental would need to sell a "build and hold" system" and recover a fair return to its investors. Thus, even in the acquisition model, assuming actual acquisition costs the return is *not above the returns to investors in similar enterprises of comparable risk—and they are therefore by definition not monopolistic.*

In addition, acquisition "premiums" are often fully justified by the economies which the buyer believes it can achieve in the system. In the example we offered, Continental's acquisition of the Fresno system from McClatchy acquisition was followed by system upgrade, remarketing, improvement of customer service, and consolidation with its other Northern California operations, all as proposed in the venture analysis on which Continental based its "bid" price. These are all desirable improvements of benefit to customers, and the economies Continental achieved fully justified the purchase price. Yet most of that purchase price is reflected in the "intangible" "acquisition premium" which the Commission is considering with such skepticism.

Our point is that there should be no a priori disallowance or presumption against intangibles in the cable television cost of service proceedings. As we detailed in Continental's comments, non-monopoly businesses and even regulated businesses are conventionally valued at well above tangible assets. Among the examples we gave in comments were resellers of telephone service, nondominant carriers, cellular properties, McCaw, the Sprint/Centel merger; the GTE/Contel merger; and the PacTel/Anchorage telephone acquisition. In each of these cases, the properties traded at significant multiples above tangible assets. These businesses are either fully competitive or heavily regulated, yet in all cases there is nothing illicit about investors recognizing the value of a company which exceeds hard assets.

The Commission is faced with one of its most sensitive decisions: establishing the safety valve which insure investors the opportunity to recover investments in building the cable television industry. If the Commission does not give fair recognition to those "intangible" investments, investors will not only be deprived unfairly of their due: they will not put their money to use building the information highway to compete with telephone. When public utilities were first placed under regulation, the courts supplied that safety valve, in the form of "fair value" cases which prevailed for 50 years. When cable television was regulated by State Commissions, they recognized the legitimacy of cable "intangibles" and foregone returns, in cases we drew to your attention in Comments. To bring cable television into this transitional phase requires a careful handling of intangibles. For build and hold systems, that treatment is to include past losses and foregone returns as an addition to book costs. For acquisition systems, the Commission should at a minimum allow a comparable amount into ratebase, allow an operator to justify any greater amount, and permit the amortization of any elements which are denied rate base treatment.

Respectfully submitted,

CONTINENTAL CABLEVISION, INC.

Paul Glist

cc: Reed Hundt, Meryl Spiegel, Blair Levin
James Quello, Maureen O'Connel
Andrew Barrett
Jay Atkinson
James Olson
Michael Katz